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Supreme Court, U.S.
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No. 03-1449

IN THE

Supreme Court of the United States

AEROQUIP-VICKERS, INC., AND SUBSIDIARIES,
f/k/a Trinova Corporation and Subsidiaries
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Sixth Circuit

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

Petitioners, Aeroquip-Vickers, Inc., and subsidiaries, submit this reply brief in support of the petition for a writ of certiorari, addressing solely the new points raised in the brief in opposition filed by Respondent, Commissioner of Internal Revenue.

Introduction

As is understandable in papers opposing petitions for certiorari, Respondent's brief is designed to narrow the issue presented and obscure the broader significance of this case. Agency efforts to disguise *de facto* amendments to their regulations issued after notice and comment by issuing "rulings" or informal interpretations that extend beyond the fair import of the regulatory language is a phenomenon troubling the courts of appeals and commentators across a wide range of administrative agencies. It is not limited to the Commissioner of Internal Revenue. The availability in this case of an expert assessment of what meanings the regulatory language could bear, as opposed to the Commissioner's self-interested creation (an "interpretation") of a step-transaction approach missing from the regulation he purports to interpret, provides the Court with a particularly helpful context from which to address this problem.

Moreover, this case offers the Court a second opportunity in the coming Term to address the important question of the authority of the Tax Court, a court of national jurisdiction, in the context of 26 U.S.C. §7482 (I.R.C.). In April 2004, the Court granted certiorari in two cases, now consolidated, *Estate of Kanter v. Commissioner*, 337 F.3d 833 (7th Cir. 2003), *cert. granted*, 72 U.S.L.W. 3672 (U.S. Apr. 26, 2004) (No. 03-1034), and *Ballard v. Commissioner*, 321 F.3d 1037 (11th Cir. 2003), *cert. granted*, 72 U.S.L.W. 3672 (U.S. Apr. 26, 2004) (No. 03-184). Among the questions presented in these cases, which address the Tax Court's

ability to prevent the findings of facts and law of Special Trial Judges from being disclosed to taxpayers, is "[w]hether this secretive process is consistent with 26 U.S.C. §7482, which provides that Article III courts must review Tax Court decisions just as they would decisions of a U.S. district court[.]" *Ballard,* 72 U.S.L.W. 3672 (U.S. Apr. 26, 2004) (No. 03-184). This case similarly presents an opportunity for the Court to define the boundaries of the jurisdictional mandates established in section 7482 and to do so in the context of a regulatory-interpretation predicament that cuts across all administrative agencies.

Discussion

I. Section 7482(c)(1) and Its Proper Application by Courts of Appeals Is the Cause for this Petition.

Respondent's opposition to this petition for a writ of certiorari turns ultimately on a re-interpretation of the issue presented. As Respondent describes it, the issue is simply the appropriate standard of review a circuit court should apply to Tax Court decisions on questions of law. Gov't 5. Respondent then maintains that Petitioners failed to raise that issue below and should not be permitted to do so here. Gov't 5-6.

Respondent misconstrues – or simply sidesteps – the actual issue presented by the petition.

A. The Issue Is How Courts of Appeals Must Discharge their Responsibilities to Determine that Tax Court Decisions Are "In Accordance with Law" under Section 7482(c)(1).

Despite the Respondent's re-framing, the issue is not whether a circuit court, when reviewing a Tax Court decision, should consider questions of law-application "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury," *i.e.*, *de novo*, under I.R.C. §7482(a)(1). There is no dispute that it must. Gov't 6; Pet. C.A. Br. 16; Gov't C.A. Br. 26. The actual issue

presented is more difficult – and more in need of this Court's guidance: when the Tax Court interprets a notice-and-comment regulation and decides that an informal ruling issued by the Commissioner of Internal Revenue is inconsistent with it, how must a circuit court decide that the Tax Court's decision is not "in accordance with law" under I.R.C. §7482(c)(1) before overruling it. *See* Pet. 9-10.

Respondent failed to reference I.R.C. §7482(c)(1) – in any manner – in the brief in opposition.

Although relying entirely on I.R.C. §7482(a)(1), Respondent ignores the implication of a standard of review for the Tax Court comparable to that of a district court "tried without a jury." For questions of law *simpliciter*, there is no difference in courts of appeals' review of district court judgments – whether reached with or without a jury. Congress's use of the limiting formula of "tried without a jury" thus shows that section 7482(a)(1) addresses review of Tax Court determinations of questions of fact and of law-application, overturning this Court's decision in *Dobson v. Commissioner*, 320 U.S. 489 (1943). It is section 7482(c)(1) that sets the responsibility of the court of appeals as to questions of law alone. As discussed in the petition (Pet. 12), this Court has not ruled on the meaning of section 7482(c)(1) in light of Congress's amendment to section 7482(a)(1).

To comply with its obligations under I.R.C. §7482, therefore, the Sixth Circuit was required to analyze the Tax Court's judgment under both I.R.C. §7482(a)(1) and I.R.C. §7482(c)(1). It is this tension between sections 7482(a)(1) and 7482(c)(1) that gives rise to this petition. Pet. 9-13.

The Sixth Circuit, like the Respondent here, failed to address – in any manner – the Tax Court's judgment under section 7482(c)(1).

B. The Issue Presented in this Petition Arose upon the Sixth Circuit Improperly Deferring to the Commissioner's Informal Ruling over the Tax Court's Fully Reviewed, Effectively En Banc, Decision.

Respondent states that this petition need not be considered, because the Petitioners have not disputed the *de novo* standard of review, which is, as Respondent maintains, the issue. Gov't 6. While Respondent is correct that Petitioners have not disputed the propriety of the *de novo* standard, the issue arose solely from the Sixth Circuit's own failure to fulfill its jurisdictional mandate. It was not presented to the Sixth Circuit because it arose from the Sixth Circuit's decision.

The Tax Court determined that the Commissioner's informal ruling did not comport with the language of the notice-and-comment regulation. What Petitioners could not have anticipated was that, in considering the Tax Court's judgment, the Sixth Circuit would ignore the restraints on its own authority that section 7482(c)(1) commands. The Sixth Circuit having further failed to correct its interpretative mistakes following a petition for rehearing and rehearing *en banc*, the need for this Court's review became apparent. Because of the Sixth Circuit's decision, and its neglect of section 7482(c)(1), the issue remains appropriate for review – even if raised for the first time. "An issue is not lost if it could not have been considered, or was raised and not considered, on an earlier appeal." CHARLES A. WRIGHT, ARTHUR R. MILLER, AND EDWARD H. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4478.6 (2d ed. 2002). *Cf. United States v. Speers*, 382 U.S. 266, 278 n.22 (1965) ("The §67b argument raised in this Court differs from that rejected below . . . . Insofar as it is relevant to the particular problem of statutory construction presented by this case, we regard the §67b argument as properly before us."). Moreover, section 7482 is a jurisdictional statute. Issues concerning the courts of appeals' exercise of jurisdiction and the powers inherent

may be raised at any time, as this Court has long recognized. *See, e.g., City of Gainesville v. Brown-Crummer Investment Co.*, 277 U.S. 54, 59 (1928).

At bottom, the question here concerns competition between the view of the Commissioner and the view of the Tax Court on a simple question of law, not any difference between review of a district court and review of the Tax Court. The Sixth Circuit deferred to the Commissioner's informal interpretation of a notice-and-comment regulation. It gave no deference to the Tax Court, a court of specialized expertise, which found that the possible interpretations of the regulation's language did not include that posited by the Commissioner, a "party to this dispute." Pet. App. 19a. Like the determinations courts make in applying the first step in analysis under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), the question whether regulatory language permits a purported interpretation is a simple question of law – the responsibility of a court (here, initially, the Tax Court) and not an agency (here, the Commissioner). *See id.* at 2781, n. 9. To prefer the Commissioner's informal interpretation over the Tax Court's at *Chevron* "step one" is to deny this proposition. This error allows agencies to undermine the normal public procedures for notice-and-comment rulemaking by effectively amending their regulations through informal interpretations that are wholly outside the language of the regulation being interpreted. This, they may not do. *See, e.g., Central Laborers' Pension Fund v. Heinz*, 124 S. Ct. 2230, 2238 (2004) ("[n]either an unreasoned statement in the [Internal Revenue] manual nor allegedly longstanding agency practice can trump a formal regulation with the procedural history necessary to take on the force of law."); *United Dominion Indus. v. United States*, 532 U.S. 822, 838 (2001) ("[t]o the extent the Government disagrees [with the approach of the consolidated return regulations], it may amend its regulations to provide for a different one.").

Providing appellate courts with appropriate direction in these circumstances is particularly opportune. For the Tax Court, as noted in the petition, this is underscored by two trends: the increasing percentage of tax cases heard in the Tax Court (Pet. 13-14); and the increasing amount of informal guidance issued by the Commissioner relative to regulations (Pet. 15 –16). By considering this petition, the Court has the opportunity to provide the needed analytical tools for appellate courts to fulfill their obligations when reviewing Tax Court decisions. And it will also provide the Court the opportunity to address the ever-increasing trend in the administrative law arena of agencies that seek to avoid the rulemaking procedures by relying on spurious interpretations in lieu of simply amending their regulations in the first instance.

II. The Tax Court's Rejection of the Step-Transaction Doctrine, and Its Holding that Rev. Rul. 82-20 Was Inconsistent with the Legislative Regulations, Was "In Accordance with Law."

Respondent also states that the Sixth Circuit's judgment is supported by an alternative ground that does not implicate the Sixth Circuit's preference for the Commissioner's informal ruling over the Tax Court's analysis, namely the "step-transaction" doctrine. Gov't 9. The step-transaction doctrine is, however, the sole basis of the Commissioner's informal ruling, and its applicability is undermined not only by the undisputed, stipulated facts, but also by the legislative regulation *per se*. The Sixth Circuit's misapplication of the step-transaction doctrine highlights its failure to apply the necessary rigor to the Tax Court's analysis under I.R.C. §7482(c)(1).

A. Revenue Ruling 82-20 Expressly Relies on the Step-Transaction Doctrine.

The step-transaction doctrine is not a separate basis for the Sixth Circuit's decision. The Commissioner's informal interpretation of 26 C.F.R. § 1.1502-3(f)(2) (Treas. Reg.) in Rev. Rul. 82-20 does not rely on anything *other than* the step-transaction doctrine.

> When there is no intention at the time of transfer to keep the property within the consolidated group, the transaction should be viewed as a *whole* and not as separate *individual* transactions. . . . Because the transfer [of the section 38 property] from P to S is a *step* in the planned transfer of the property outside the group, [the exception in] section 1.1502-3(f)(2)(i) of the regulations does not apply [to this transaction]. . . . Therefore, the transfer from P to S is a disposition under section 47(a)(1).

Rev. Rul. 82-20, 1982-1 C.B. 6, 7 (emphasis added). The step-transaction doctrine underlies Rev. Rul. 82-20 in the first place; it is the only basis for the Sixth Circuit's decision.

B. The Commissioner Stipulated to the Facts that Make the Step-Transaction Doctrine Immaterial.

The Respondent neglects to mention that the Respondent stipulated to the facts that make the application of the step-transaction doctrine immaterial. Indeed, the Sixth Circuit panel-majority's finding that the step-transaction doctrine may still apply required a determination that the Tax Court's decision was clearly erroneous; the Sixth Circuit provided no justification for any such holding.

In the Tax Court, the Commissioner stipulated to the propriety of the Petitioners' corporate reorganization under I.R.C. §§368(a)(1)(D) and 355. Pet. App. 44a. The Commissioner thus conceded, *inter alia*, that the reorganization was "not used principally as a device for the distribution of the earnings and profits" of Libbey-Owens-

Ford or of LOF Glass.[1] *See* I.R.C. §355(a)(l)(B). The Commissioner admitted that Libbey-Owens-Ford and LOF Glass were engaged in the "active conduct of a trade or business" both before and after the transaction. *See* I.R.C. §§ 355(a), (b). As Judge Tannenwald stated for the Tax Court, "[b]y so doing, respondent has stipulated that there was a business purpose, *i.e.*, substance, to the transfer by petitioner to LOF Glass, Inc., a position which is inconsistent with her position herein that petitioner disposed of the assets by in effect transferring them to Pilkington Holdings." Pet. App. 54a.

Having stipulated to the propriety not only of each step but also of the entire reorganization and split-off, the Commissioner by necessity stipulated to the reorganization's overall substance and legality. The Commissioner cannot now claim, nor was it supportable for the Sixth Circuit to hold, that, for investment tax credit purposes alone, the transaction should be ignored. If the Petitioners' corporate transfers had real and economic viability and thus were not merely tax-avoidance transactions, then all aspects of the reorganization must stand.

A prerequisite for the step-transaction doctrine is a tax avoidance motive. *See, e.g., Gregory v. Helvering*, 293 U.S. 465 (1935). As part of his detailed analysis of the panel-majority's misapplication of the step-transaction doctrine, the dissenting Sixth Circuit judge noted the panel-majority's inherent illogic:

> I have no idea how a party could possibly intend several steps to achieve various legitimate business purposes but simultaneously intend the *series* of

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[1] As described in the petition, Aeroquip-Vickers, Inc., operating as the Libbey-Owens-Ford Company at the time ("LOF"), transferred its glass manufacturing division to a wholly owned subsidiary, LOF Glass, Inc. ("LOF Glass"), in 1986. Approximately two months later, LOF transferred all of the stock of LOF Glass to one of LOF's shareholders, Pilkington Holdings ("Pilkington"), in exchange for Pilkington's shares in LOF.

> steps to accomplish an illegitimate tax-avoidance objective.

Pet. App. 38a (J. Clay, dissenting) (emphasis in original).

C. Rev. Rul. 82-20 Is Directly Contrary to the Legislative Regulations It Purports to Interpret.

In determining the acceptable range of interpretations of Treas. Reg. § 1.1502-3(f)(2)(i) and its examples, the Tax Court concluded that the language of these legislative regulations was clear, holding that, first, when property for which a taxpayer obtained an investment tax credit ("ITC") (known as "section 38 property") is transferred to a member of its consolidated tax group, then the transfer itself does not trigger an obligation to repay or "recapture" the ITCs. Second, it is the "transferee" that assumes the obligation to repay the ITCs in connection with the section 38 property, and it is only when the transferee disposes of the section 38 property or ceases to use it in its business that it may be liable for the ITC recapture. The **transferor** has no further obligations with respect to the section 38 property. And, third, when the stock of the transferee is subsequently transferred, no ITCs must be repaid. Pet. App. 47a - 48a.

The Commissioner argued, and the panel-majority below agreed, that Rev. Rul. 82-20 limits the application of Treas. Reg. § 1.1502-3(f)(2)(i), despite being a "legislative" regulation issued after notice and comment. *See Wolter Construction Co. v. Commissioner*, 634 F.2d 1029, 1032 (6th Cir. 1980); *see also United Dominion*, 532 U.S. 822 (2001). Under Rev. Rul 82-20, these regulations are applicable only when the parties transfer the section 38 property with an intent to keep the property within the consolidated group for some period of time, minimally one tax year. Rev. Rul. 82-20, 1982-1 C.B. 6. Thus, in this case, dispensing with the Tax Court's analysis, the Commissioner and the panel-majority imposed an obligation on the **transferor** – not the **transferee** – to repay the ITCs.

The rub, as the Tax Court's analysis confirmed, is that there is nothing in the regulation that imposes an "intent" requirement. There is no "timing" requirement. There is no "integrated-" or step-transaction-analysis requirement. Where the notice-and-comment regulation imposes liability on the transferee, the Commissioner's informal interpretation imposes it on the transferor. In short, the Commissioner's informal ruling shifts the ITC repayment obligation to the wrong taxpayer. The Tax Court rightly found Rev. Rul. 82-20 to be excluded from the realm of interpretive possibilities of the language of the Treasury regulation. Its analysis was therefore "in accordance with law" under section 7482(c)(1).

CONCLUSION

For the reasons stated in the petition for a writ of certiorari and this reply brief, the petition should be granted

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